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CHALLENGES FOR STABILITY POLICY[1] IN TERMS OF FINANCIAL MARKETS INTEGRATION

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Introduction

The depth and size of the crisis lasting for at least a year on international financial markets made it clear that present architecture of financial security system is very fragile. Globalization and integration of financial markets is accompanied by their constant national institutional order and national responsibility for financial stability policy as well, despite of attempted cross-border coordination. New supranational caution regulations (mostly *Basel II*) are implemented by national institutional structures. It gives rise to hybrid solutions (i.e. *home and host country supervision*), which cause separation of regulating and supervising competence from their responsibility. It is worth mentioning that sources of contemporary crisis are separated from their expensive consequences as far as particular institutions are concerned and financial markets sectors and countries as well. Does observation

[1] By financial stability policy I mean the whole of activities and regulations conducted in order to even out system risk.

of the crisis on integrated financial markets lead to any conclusions for stability policy (financial security) in host countries such as Poland?

Contemporary crisis on international financial markets has some features and mechanisms due to development tendencies of global financial markets that were never found before or were never of any significance. This crisis is different – states Alan Greenspan, former president of Federal Reserve. "It is not similar to previous episodes destabilizing economy which temporarily frosted liquidity. (...) Once or twice in the century there is an event that has its source in fears of solvency of general financial institutions"[2]. Present crisis is also record expensive for tax payers. The authors of UBS report estimate that American taxpayers had to pay 945 billion USD for helping bank groups. The support of the US government amounted 6.9% of GDP and for comparison the support during the Great Depression reached 2% of GDP, and during the crisis of savings and loan funds in the eighties – 3% of GDP. The support is over 300 billion USD larger then the help of Japanese government during banking crisis in the nineties[3].

The depth, size and spreading mechanism of the crisis make us wonder what the difference is between the present situation and classical banking crisis because only the correct diagnose allows taking adequate precautions. It seems proper to point out a few issues:

1. Expanding definition of system risk.
2. Unreliability of contemporary risk managing models.
3. Methods of avoiding risk.
4. Crisis spreading methods.
5. Stipulated politician and regulator reactions.

1. Expanding Definition of System Risk

Traditional, classical understanding of system risk[4] that was connected mostly with credibility loss of banking system for deponents got significantly expanded. The deposits are no longer main source of banks activities financing. Safe bank

[2] A. Greenspan, *It is not possible to allow limiting competitive markets*, "Financial Times" of August 5th, 2008, [in:] http://ft.onet.pl/11,13182,nie_mozna_pozwolic_na_ograniczenie_konkurencyjnych_rynkow,artykul.html.

[3] P. Craig, H. Wilson, Costs of crisis in the US *reach billions of dollars*, "The Wall Street Journal" [in:] "The Wall Street Journal Poland. Financial Daily" of August 6th, 2008, p. 10.

[4] "There was system risk in traditional commercial banking whenever panic paralyzed normal activity of credit institutions. At the same time many deponents requesting the bank to make a payment of funds caused emptying the volt and the loss of liquidity of the bank. (...) As far as traditional central banking is concerned the system risk regards the breaking of calculation and accounting system." J. K. Solarz, *Financial system risk management*, PWN, Warsaw 2008, p. 46, 47.

functioning depends not only on the trust of deponents. More and more it requires credibility on widely interpreted market of capital acquisition. Liquidity of banks depends on their credibility on financial market. Meanwhile through the global market of derivative credit instruments the credit crisis spreaded over to insurance institutions, investment funds, investment banks and other institutions that are not professionals in credit risk managing but are capital providers for banking sector. The loss of liquidity or solvency of capital providers of credit institutions due to radical decrease of their assets value causes enlarging system risk and can lead financial system break. Decrease of investing attractiveness of investment funds makes the financial market repelling for savings and enlarges problems. Investment funds only temporarily transfer the entire risk to investors. They play so important role in financing other institutions that loss of their attractiveness for investors creates a significant system risk. Investors by searching for alternative methods for investing their savings additionally stimulate increase of prices of raw materials and energy on futures exchange. As a result system risk was begun to be generated by institutions that traditionally were never interesting to central banks. Central banks have to support liquidity on financial markets in order not to transform financial crisis into general economic crisis[5]. They prevent from bankruptcy not only banks but also other financial institutions. As a result financial institutions become more and more depending on central banks. Many banks exchange mortgage loans into commercial papers in order to use them as collaterals for financial acquisitions from ECB and Fed[6]. Not only natural integration procedures especially mergers and acquisitions cause increase in the number of institutions creating system risk. Also inadequate tendency of central banks to intervene incl. in preventing relatively small institutions form bankruptcy[7] expands definition of system risk and causes too big involvement of central banks in market procedures and also creates moral gambling. Furthermore it stimulates system risk increase. Therefore central banks indirectly contribute to system risk increase.

Northern Rock – one of the biggest mortgage banks was nationalized not only because it had “bad” assets, but also because nobody was willing to lend money for current activity. Decreasing trust of lenders to financial sector is accompanied by

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5 “Subprime crisis at the moment of bursting was perceived as the most dangerous financial crisis since the thirties. It was critical to prevent political mistakes that used to transfer crisis into macroeconomy catastrophy. The lesson of it was that it is important to prevent too much binding in monetary policy.” *Fed can learn on history mistakes.* “Financial Times” of August 19th, 2008 [in:] http://ft.onet.pl/11,13671,fed_moze_sie_uczyc_na_bledach_historii,artykul.html.

6 Compare to C. Mollenkamp, *Banks facing new financial crisis*, “The Wall Street Journal” [in:] “The Wall Street Journal Poland. Financial Daily” of August 28th, 2008.

7 Roskilde Bank can be given as an example. Roskilde Bank is an 8th biggest bank in Danmark with 24 branches and 100.000 clients taken over by Central Bank of Danmark in August 2008.

decrease in investment attractiveness. Estimated value of European and American financial institutions (banks, insurance companies and assets managers) lowered significantly – by 2,7 trillion USD which is a year GDP of Great Britain – because of credit crisis.

Table 1. Decrease in market value of stocks of financial institutions (difference from their stock exchange record till the end of July, 2008 in billions of USD)

European banks **(33)**	**–1 457**
American universal banks **(5)**	**–463,9**
European insurance companies/asset managing **(27)**	**–336,4**
American investment banks **(6)**	**–220,8**
American insurance companies/asset managing **(19)**	**–194,4**
Stock exchange companies managing alternative assets **(13)**	**–38,0**
In parentheses there is the number of institutions	

Source: P. Craig, H. Wilson, Costs of crisis in the US *reach billions of dollars*, "The Wall Street Journal" [in:] "The Wall Street Journal Poland. Financial Daily" of August 6th, 2008, p. 10.

Decrease in values of financial companies was twice as big compared to the decrease in general stock exchange index (Index Standard&Poor's loses 18%, while American investment banks 57%), which means that decreasing trust to supervised institutions governed by precautions regulations was much bigger then to unsupervised companies. The faith of investors in supervisors' effectiveness has significantly weakened. The risk of losing reputation was considerable for all market participants:

- loaners that lost credibility to repay of liabilities,
- lenders that seemed to transfer credit risk to capital market,
- credit rating agencies which ratings turned out to be useless,
- supervisors and regulators that were not able to take preacautions in proper time,
- investment funds that "guaranteed" investors the loss of capital,
- financial institutions managers that destroyed value for shareholders.

System risk is generated by deepening loss of trust of potential investors to many financial market participants and that is the reason why the crisis was not terminated by world central banks providing enlarging liquidity in short period of time. Not until private banks (Northern Rock, Bear Stearns) and credit institutions such as Fannie Mae and Freddie Mac were granted government guarantees the market seemed to stabilize. Banks dependence on liquidity of financial market caused system risk to bind tighter and even identify as reputation loss risk on the market of capital acquisition by financial institutions, not only the banks.

2. Unreliability of Contemporary Risk Managing Models

What seems the most surpising is the fact that the crisis occurs in time of the banks setting new models of risk managing basing on IT and telecommunications technologies that were only dreamt of a few years ago. “The revolution of last few years as far as risk managing is concerned was all about spreading derivative instruments and methods of estimating the number of potential losses. (...) The possibility of estimating potential losses makes it possible for certain financial institution to distinguish eventual risk in order to prevent shortness in capital to cover potential losses”[8]. Furthermore the banks that were set as an example of proper activities in terms of risk managing have serious financial difficulties and claim losses of billions. It is worth reminding that some of such banks initiated many financial regulations including Basel II. The models of risk managing consisted in Basel II are identical with the ones used in previous years by the largest banks of the world presently claiming giant losses. Contemporary concepts of risk managing are usually a part of larger system – system of managing values for shareholders. The clue of such system is to reach the maximum risk adjusted rate of returning self capital (RAMP, RAROC, RARORAC, etc.) Basing on such criteria the capital is allocated. The subject of analysis is how banks self capital differs from estimated economical capital necessary for covering undertaken or planned risk. Ideal is the situation when estimated economical capital is identical with regulative capital required by external supervising institutions. If the self capital overwhelms estimated economical capital it is interpreted as non-used capital of shareholders. In other words the surplus of self capital over estimated capital necessary for covering potential losses is taken for “disability measure” of capital used by bank management. In general implementing such concept in banks is to be evaluated positively. It is worth noticing though that risk managing and economical capital estimating are on one side under pressure of returning rate for shareholders which package of shares in bank capitals are relatively small, on the other side occur in the environment of “abuse temptation” due to increasing predictability of central banks in situations of financial liquidity crisis. Such situation makes it less cautious to perform activities at the risk of taxpayer. It encourages financial market participants to underestimate risk.

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8 A. Slawinski, *Financial markets*, PWE, Warsaw 2006, p. 196.

Present system of risk estimating especially determining capital adequacy shall require comprehensive supervision in terms of previous experience. New international regulative agreement so called Basel II shall probably require improvement. In Alan Greenspan's opinion imperfection of the latest models of risk management is due among others to the fact that they are based on time sequence of data taken from expansion periods as well as periods of recession. In the last 50 years American economy was in recession only for 1/7 of the time. "But just for this 1/7 risk management shall be most properly prepared"[9]. The strategy of diversification of portfolio based on negative bindings of various types of assets during expansion period can be disappointing in time of crisis when prices of all assets fall down. Some experts describe such risk as model risk or accounting risk due to theoretical model inconsistencies performed in the real world or too optimistic view of financial situation of economic entities in financial reports. They give "creative accounting" of Enron holding[10] as an example. Some take such risk for kind of executive risk. Anyway, no matter how it is classified it is obvious that there is conflict of interests between motivation systems orientated towards short terms increase of value for shareholders and stabilized development of financial institutions[11]. And as such, for example whenever 30 year credit decision is being made usually 3 year management contracts are signed. Implementing more and more complex formal procedures is to eliminate such conflict. Bankers are thus constantly under huge pressure of results and effectiveness of formal procedures being lower then expected[12]. Present motivation system especially the system of remuneration in financial institutions is a source of too big expansion.

3. Methods of Avoiding Risk

It is very typical for present procedure of loaning to prevent credit risk by most of financial market participants. From the point of view of single entity it is a value added for the owners but in terms of overall activity it leads inevidibly to catastrophy. Enlarging competition encourages lenders to offer mortgage loans without proper credit collateral such as those exceeding the sale value of real

[9] A. Greenspan, *We will never have a perfect model of risk,* "Financial Times" of March 17th, 2008, [in:] http://ft.onet.pl/11,7690,nie_ma_doskonalego_modelu_ryzyka,artykul.html.

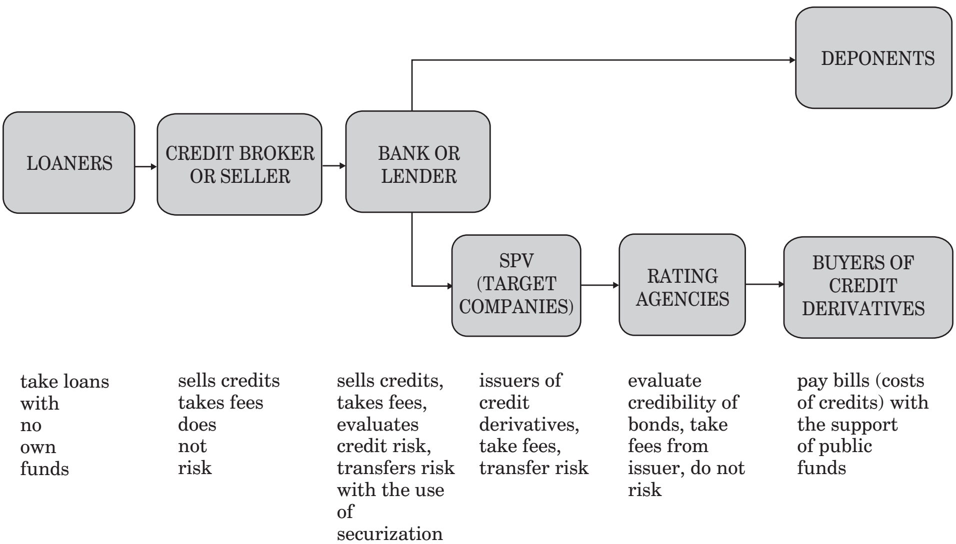
[10] K. Jajuga, *Theoretical basis of risk management,* [in:] *Risk management*, ed. by K. Jajuga, PWN, Warsaw 2007, p. 25.

[11] Ackermann J., *How can banks regain trust*, "Financial Times" of July 31st, 2008, [in:] http://ft.onet.pl/11,13059,jak_banki_moga_odzyskac_zaufanie,artykul.html.

[12] Compare to H. Simonian, *The management of UBS was aware of law breaks,* "Financial Times" of August 13th, 2008, [in:] http://ft.onet.pl/11,13562,kierownictwo_ubs_wiedzialo_o_lamaniu_prawa,artykul.html.

estate. The loaner at the moment of taking a loan without so called own funds does it with no risk. The loan seller like the broker or banker is remunerated usually by progressive accord (the more loans are sold the higher commission is taken). It is also performed with no credit risk. Credit risk is all on lender and potential insurer. The lenders in more and more cases transfer risk to other market participants with the use of securitization. In the process of transferring risk the fees are payed to the order of target companies, rating agencies and investment banks, but they prevent risk as well. As a result the costs of credit risk are taken on investors that purchased derivative credits and in case of lack of securitization on banks and deponents. Such process is illustrated by Figure 1.

Figure 1. Share of certain financial market participants in credit risk



Source: Self prepared.

In such process there are at least three elements generating crisis situations.

First of all, at the moment of making credit decision it is very easy to cumulate recklessness of the loaner and impunity of the seller or broker.

Secondly, as a result of securitization it is possible to not only transfer credit risk to institutions not prepared for credit risk managing but also to cause decrease in banks interest in long terms credit policy, credit administration, credit vindication and potential restructuring.

Thirdly, the conflict of interests in rating agencies remunerating by issuers and lack of clearness and supervision enlarge the risk of loss of trust among credit market participants.

As a result in the entire chain of acquisition capital for crediting activity the consequences are focused in its last link, but there is system risk generated and is ultimately to be beared by all participants also as far as public funds are concerned.

4. Crisis Spreading

It turned out to be surprising that securitization of banks assets generated crisis while it was perceived as system risk reduction measure.

The present crisis showed that securitization of banks assets generates some situations contrary to what is expected.

First of all, securitization of mortgage loans has become the major channel of spreading crisis among lenders and loaners. It has made the system risk of financial markets enlarge instead of diminish.

Secondly, the transfer of credit risk from credit institutions to MBS buyers i.e. mainly investment funds and insurance companies makes banks that are already free from risk stopped caring for quality of credit portfolio. The risk is spread among investors all over the world and banks along with eliminating credit risk carelessly begun to stipulate sales of credits with no own funds and without reliable evaluating loan credibility. It is estimated that such risky credits stand for over a half of all mortgage loans in the US through years 2005–2007.

Thirdly, securitization of mortgage loans has become an encouragement for moral gambling, as a result of which there has been created the whole chain of agents profiting from fees and not taking any risk (compare Figure 1). Credit brokers and multibrokers just like banks try to maximize income by selling more and more credit products and consecutively banks transform them into securities guaranteed by mortgage loans. Furthermore investment banks take fees transforming mortgage obligations into collateralized debt obligations (*CDO)*. Moreover there is conflict of interests in rating agencies because they take fees from the managements of the companies transferring credit risk. Investors observing increase in real estate prices buy MBS and CDO believing disappointing ratings, despite of the obvious of the fact that correct evaluation of complex inliquid measures is almost impossible.

Fourthly, securitization has lowered financial market transparency because the structure of buyers of mortgage collateralized securities and their market value are unknown. As a result when nobody knows what the other has credibility of partners decreases and it leads to lending money difficulties that is to the crisis.

The largest danger to Polish financial market stability is thus the mechanism of credit expansion identical with the one in the countries that are presently living through credit crisis. In such mechanism fast growth of mortgage loans is encouraged by cheap, easily accessible credit.

Banks create credit money faster then the value of real estate offered for sale increases. On the real estate market there is typical demand inflation being noticed (accompanied by credit) Real estate prices are not "included" in an index of product and consumer services price (CPI) that is a most popular measure of inflation and it does not influence directly an evaluation of realizing inflation aim in terms of monetary policy.

Leaving academic discussion on the side whether an apartment is a consumer good or investment capital, it is worth mentioning that real estate market inflation generated by a mechanism of too large credit expansion is increasing powerly. Such situation occurred in many countries, Poland as well. As a result of powerly inflation on real estate market loaners get bigger and bigger loans even balancing on the edge of their financial credibility.

Loaners' monthly burdens of credit installments change slower then apartment prices because credit period is prolonging sometimes to eternity and banks under pressure of enlarging competition make their offers attractive for loaners at the beginning in terms of credit products. As a result the process of credit expansion characterizes of powerly increase to the extent of crisis.

Rate of increase of credit expansion and related powerly inflation on real estate market sooner or later lead to the situation of the loaners not being able to repay installments. The mechanism of credit expansion is at the moment out of control and changes into the mechanism of crisis. Since that moment financial system stability loss protection requires very expensive interventions of central bank. The costs of crisis management are incomparably higher the costs of preventing actions.

5. Stipulated Politician and Regulator Reactions

For national regulators and supervisors the clue is an answer to the question: whether or not and how to intervene in credit expansion mechanism?

Is uncontrolled, powerly growth of mortgage loans accompanied by increasing inflation on real estate market supposed to be regulated with monetary policy instruments or with precautious and supervising measures?

Up to now experience of countries going to credit crisis shows that there is according precaution missing there. The fact that market participants used moral gambling does not seem surprising because such activities are generated by credit expansion mechanism. As a result there is a situation when central banks in countries with the crisis by implementing financial liquidity into banking system create certain value for shareholders because they do not let the share values of such institutions drop adequately to undertaken risk. They lower percentage rates in spite of inflation risk because they would not let the prices on the real estate market fall because they are collateralizations of mortgage loans. In fear of triggering off the crisis mechanism they allow inflation growth. We observe the results and activities contrary to what we expected.

Poland is at the beginning stage of mortgage loans expansion[13]. It seems that presently it is enough to undertake moderate precautious and supervising measures in order to prevent serious problems. Such activities shall be synchronized with economical and social policy and shall be focused on determining prices on real estate market.

The prices of real estates are a significant element of credit expansion mechanism as well as the crisis mechanism. It is a radical price drop that causes market value of mortgage loans collateralizations to become delusive what is a direct reason of transferring credit expansion mechanism into the mechanism of crisis. Decreasing prices of real estates lead to demand fall of mortgage loans on one side and aggravating of banks' credit policy on the other. What happens is the loan demand falls down as a result of aggravated credit policy. Furthermore if the price of credit increases meanwhile due to for example percentage rates increase or currency risk growth the fall of demand of real estates and drop in prices is more radical what makes crisis costs grow. The crisis of contemporary loss of liquidity transforms into the crisis of solvency of financial institution and this causes not only the loss of reputation of single banks but also serious loss of trust on the entire financial market endangering its stability.

The previous source of crisis is stil mortgage loans expansion mechanism generating false assumptions of risk management mostly as a result of revaluating collaterals due to uncontrolled real estate prices increase. Such situation occurs presently in the United States. In Alan Greenspan's opinion "the solvency crisis is going to end as soon as the prices of houses in the US begin to get stabilized and it

[13] The share of Poland in European mortgage loans market is not adequate neither to demographic potential of Poland nor to economical potential. As such, the share of Poland in EU-25 is described as follows:
– 8.3% in population
– 7.0% in employment
– 2.4% in GDP
– 0.4% in mortgage loans.
The number of sold mortgage loans in the European Union has exceeded 6 trillion euro in 2007. It is about 40% less then in the United States. The ratio of sold mortgage loans to GDP is in the European Union about 50%, in Poland about 10%.

would be possible to determine their real value that shall be an ultimate collateral of most of mortgage securities of the financial world”[14].

The more significant role is played by mortgage loans in terms of financing people and corporations and the larger is the scope of refinancing banks on financial market the bigger crisis is to be expected.

We try to find it reassuring that there are no issuers of credit derivatives in Poland and there are no investors interested to buy them. We also try to find it reassuring that there are no *subprime* credits in Poland because the loans of the population is relatively low and the sector of mortgage loans loaners consists in families relatively richer. It is worth noticing though that the definition of *subprime* credits is verified not until in the stage of crisis on the real estate market. How many loaners will stop repaying installments in case of percentage rates increase, we are able to evaluate. But how many of them will stop repaying installments of mortgage loans in case of the prices drop for example by 25%, not because they cannot afford to repay but because they will find repaying installments unprofitable, we are not able to evaluate. Sometimes it is determined by consequences of negative value of collaterals. No own funds of the loaner will encourage such activities. Research[15] show that financial morality of Polish people is low as for example only almost 50% radically states that not repaying loans is reprehensible and that installments shall be definitely repayed.

Reseach conducted by the Institute of Market Economy Research in April 2008 (in seven commercial banks of which accommodation loans have share of 60% in total number of accommodation loans) point out that crediting practice of banks in terms of loans should be more cautious. It referres especially to:

❖ Calculating minimum costs of family support (many banks offer credits of a single installment exceeding safe lavel of 50% PTI, do not consider percentage rate of risk while calculating credibility and the funds left after repaying installment are below social minimum);

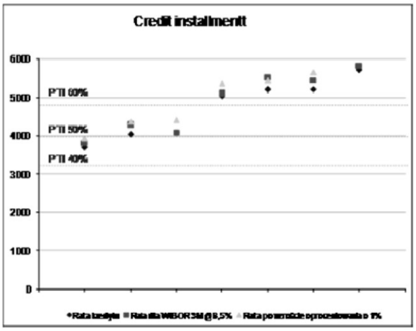
[14] A. Greenspan, *It is not possible to allow limiting competitive markets*, op. cit.

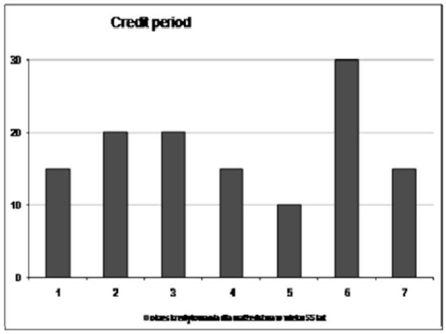
[15] A. Roter, *Deserved dynamics and financial morality of Polish people*, Forum of Banking 2008, Warsaw March 12th, 2008.

Loans for the elderly

Banks' offers for couples at the age of 55 with monthly net income of 8.000 PLN*

* Introductory results of a survey of IMER of April 2008.



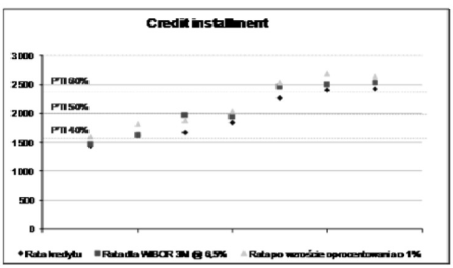


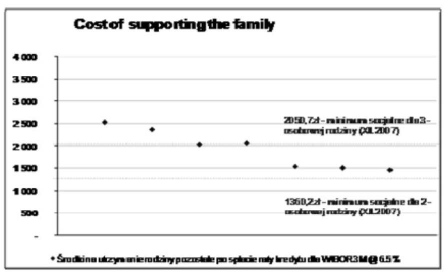
- Many banks offer loans of single installment over 60% PTI
- No surveyed bank considers the possibility of lowering income on pension
- Only one bank considers the maximum period of crediting until the loaners turning 65.

Loans for young couples (just married)

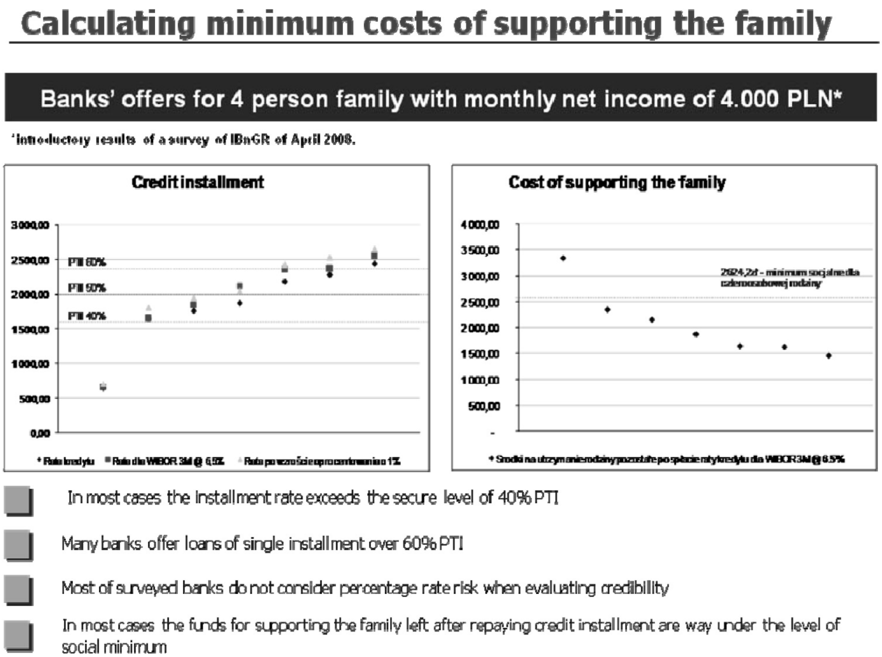
Banks' offers for just married couples with no children with monthly net income of 4.000 PLN*

*Introductory results of a survey of IBnGR of April 2008.





- Many banks offer loans of single installment over 60% PTI
- The funds for supporting the family left after repaying credit installment are over the level of social minimum for 2 person family
- No surveyed bank considers in the procedure of evaluating credibility the possibility of lowering income and enlarging life expenses after having a child



Source: A. Saniewski, *The rules of responsible crediting*, conference materials of Gdanskiej Academy of Banking "Financial institutions value management", Gdansk April 24th, 2008.

❖ Selling credits with no own funds of the loaner (LTV ≥ 100%).

Up to now point of view can lead to creating Polish *subprime* market in the next couple of years in spite of contemporarily good quality of mortgage loans portfolio.

In half of 2008 the value of irregular mortgage loans was in Poland 1.25% (compare to Spain 0.5%). Anyway these are "new" credits, 1 or 2 year. As experience shows the quality of mortgage loans decreases after 5 or 6 years. There are relatively many "new" accommodation loans also because since the end of 2007 there is a big sale of apartments on second hand market, apartments bought exclusively for later sale. The seller repays the installments and the buyer undertakes new loan. The range of such activity is determined by the fact that in the first six years of 2008 the sale of accommodation loans was about 36 billion PLN, and increase of loan debts only 20 billion PLN.

Present mechanism of mortgage loans expansion generates such dangers; credit expansion occurs in terms of preventing credit risk by the loaners, credit sellers and agents and is based on according motivation systems as the ones in the United States. Bussiness cycle in scope of mortgage loans is long and complex. Present high dynamics of banks' assets is not a serious danger to the stability of banking sector in Poland but the lack of proper caution and too liberal crediting policy unnecessarily generate crisis risk.

Present situation on mortgage loans market in Poland, which goes through the first stage of growth, enables effective preventing activities that can eliminate crisis risk. They require reducing inflation on the real estate market to one digit level. Too radical regulations or activities can cause market break as a result of radical collaterals value drop and triggering crisis mechanism. That is why the whole system of factors influencing real estate prices in Poland has to be taken under consideration. The prices are however a little bit different then in countries like the US, Germany or Spain. Next to the major causes of credit demand growth like the ones in EU such as low percentage rates, liberalization of crediting policy and expected prices increase on the real estate market, there are Polish specific factors. These are fundamental factors regarding unfulfilled basic accommodation needs. For example the number of apartments in Poland calculated for 1000 citizens is over 30% lower then in the UE and eliminating such deficit requires about 12 to 15 yeras. On the other hand the prices of apartments "are increased" by limitations in supply due to administrative reasons: lack of spatial development plans, developed areas and also long lasting construction procedures that make it possible to procede with the investment in not less then a year. The difficulties limiting real estate market supply are also due to the lack of immigration policy in terms of big employment emigration of Polish people that would eliminate the problem of no employees.

As a result the price movement on Polish realestate market is caused by the demand change due to cheap and easy to get loan and supply limitations. It all allows so called bubbles in the business cycle. Additionally the more and more important role is begun to be played by foreign demand.

In such situation further slowing demand by percentage rates increase would have to be an ultimate solution in case previous precautious or supervising measures have been impossible or ineffective. Monetary Policy Council will soon be in a peculiar position. Caring for realizing inflation aim especially while oil prices grow as well as the prices of food and remunerations the Council would be willing to increase percentage rates. On the other hand increasing percentage rates will generate risk of losing financial stability as a result of growing risk of real estate prices drop that furthermore can trigger crisis mechanism.

In other words further increasing rates can cause deflation on real estate market along with all the negative side effects, as much as decreasing the rates is one of the most important factor of triggering mechanism of too big credit expansion and powerly inflation on real estate market.

The answer to the question what level of percentage rates will equal the risk of inflation growth and the risk of losing stability is very difficult. On one side we expect effects to the reaction to monetary policy of the mechanism generating inflation on the market of consumer goods, on the other hand the reaction to crisis mechanism (deflation) on real estate market.

Presently in Poland growing percentage rates on national interbanking market cause limited effects as far as slowing down demand for mortgage loan is concerned. Most loaners calculate their credits in currency of Swiss Francs with the use of maintaining appreciation of Polish zloty. Increase of percentage rates in zlotys causes intensified substitution between mortgage debts in zlotys and swiss francs. Increase of percentage rates can be "unpunished" for a short period of time in terms of influencing real estate prices and growth of risk of triggering crisis mechanism. Present rate of 5–10% correction of prices on Polish real estate market is due to natural limitation of accommodation demand due to too big burden of home budgets with installments and resulting from growth of prices in 2006 and 2007, not from the limitation of credit supply though. It does not seem dangerous if it does not deepen by unreliable policy. Supervising activities could be limited to the restriction of selling mortgage loans with no minimum own funds for example on the level of 10% of market value of the real estate.It is also worth considering to implement the duty of insuring credits by banks if for example LTV is higher then 0.8. It would cause better market evaluation of credit risk. Such situation occurs among others in Canada which in spite of tight bindings with the US market eliminated credit risk[16]. At the same time successively but not suddenly the administrative limitations should be unlocked. It does not seem right though to continue initiatives regarding dotations to mortgage loans from public funds which stipulate additional credit expansion of the banks. The most risky scenario would be too big accumulation of activities limiting the growth of real estate prices or too radical actions, which by decrease in real estate prices would trigger crisis mechanism. Maintaining financial system stability in Poland and maintaining high rate of growth requires coordinating not only monetary policy and precautious and supervising actions but also policies economical and social.

For Poland it is crucial to learn from present crisis on American market and distinguish the necessity of participating in costs of credit risk by all participants of credit market that initiate crediting process i.e. loaners, brokers, agents, credit sellers. It results directly from the conclusion of American supervision due to the effect of analysis of the sources of present crisis[17].

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[16] More B. Lepczynski, M. Litkiewicz, M. Penczar, *Implementing in Poland insurance such as Mortgage Insurance – profits for banks and Polish banking system*, IBnGR, Gdansk 2008, copied typescript.

[17] Compare to G. N. Gardineer, *Residential Mortgage Lending: Lessons from the Current Crisis*, seminar materials of Polish Banks Association, Warsaw, November 6th, 2007.

In case of loaners it would mean the lack of possibilities to take loans with no own funds. In case of brokers and sellers it would be connected with the necessity of using remunerating systems based on so called commission banks. Commission bank (part of a deposit of remuneration for seller or broker) makes it possible to contemporarily secure the lender against the risk of unreliably sold credits. Experience of other countries shows the huge meaning of good practice codes in limiting risk of losing reputation by credit agents and banks.

The debth and characteristics of present crisis on financial markets caused politicians' reaction. They are under the pressure of higher and higher estimations of present crisis costs[18]. It has become obvious that actual architecture of financial security system *(safety net)* is unadequate to contemporary financial crisis challenges in the United States as well as in the European Union. In 2008 there are supposed to be expected initiatives which will try to solve the problem in the scope of Europe. They will not be of no meaning for long terms stability of Polish financial system. It seems that two of them can turn out to be extremely important.

First of all, the connection with proposed amendment of directives based on Basel II weakening the temptation of banks to reduce capital and requesting the banks to be in disposal of significant additional self capital not determined by risk[19].

Secondly, the connection with centralizing supervision of cross-border banks submitted in first quarter of 2008 by prime ministers of Italy and Hungary.

Generally speaking it is not possible to moderate European security system thoroughly without previous agreements as far as paying for the cross-border crisis costs is concerned. That is why the negotiations will be long lasting. It is also obvious that the European Union is not properly prepared for the crisis of even one cross-border bank. It seems enough to think what would happen if Northern Rock had branches and subsidiaries for example on Poland and in Lithuania. What would be the reaction of the Bank of England, and what would be the reaction of National Bank of Poland?

It does not change the fact that we are able to generate our own crisis for ourselves.

Present architecture of financial security system in Poland does not provide system stability in case of a little bigger difficulty. Furthermore the architecture of financial security system on so called homogeneous financial market of the

[18] Compare to M. Wolf, *The auction of terryfing scenarios*, "Financial Times" of March 12th, 2008, [in:] http://ft.onet.pl/11,7577,licytacja_przerazajacych_scenariuszy,artykul.html.

[19] Compare to H. Benink, G. Kaufmann, *The crisis uncovers failures of Basel II*, "Financial Times" of February 28th, 2008, [in:] http://ft.onet.pl/11,6997,kryzys_odkrywa_wady_basel_ii,artykul.html.

European Union is presently under constructions and it does not dispose of measures nor possibilities of eliminating results of medium cross-border crisis.

In time of crisis supervisors of home countries which in terms of implemented regulations supervise in a consolidated manner cross-borders financial groups are in a situation of classical conflict of interest: whether or not to act for the stability of financial system of the country of headquarters or to defend security of subsidiaries of the holding seated in other countries. Such situation is really uncomfortable for so called host countries consisted in most of new participants of the European Union including Poland.

The larger is the danger the deeper are the crisis on international financial markets. Presently there are no assumptions to think that crisis has been eliminated, it is more possible to expect crisis spreading. That is the reason why it is necessary to strengthen financial security system in Poland.

Regardless, Poland should actively cooperate in building new architecture of financial security system in European Union. Considering deep conflicts of interests it is going to be a long lasting process, at least couple of years long.

The directions of actions limiting the danger should refer to internal national possibilities and cooperation with other countries in terms of financial security in EU.

Active participation of Poland in building new architecture of financial security system in European Union should focus especially on:

- ❖ Acting for integrated financial supervision over cross-border financial groups being an alternative for present system of *home – host country supervision*,
- ❖ Acting for transferring material liability for the effects of cross-border crisis into federal level,
- ❖ Acting for enlarging costs participation in financial security system through cross-border financial groups.

Present crisis on international financial markets caused the situation when presumed dangers have become real.

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